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The EU CAP Reform, Context and Implications

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Executive Summary

The European Union (EU) Common Agricultural Policy (CAP) has undergone significant reforms since the early 1990s by, first, reducing reliance on market price support and a shift toward support through direct payments (e.g., the 1992 and 1999 reforms), and most recently (June 2003) by deciding to shift some of the coupled direct subsidies to decoupled direct payments beginning 2005. These reforms have important implications for Alberta's/Canada's agriculture, as for other trade participants, for at least three reasons: (i) the EU is the largest importer of agri-food products, (ii) the EU is the second largest exporter of agri-food products that compete with Alberta's/Canada's exports in the world market, and (iii) the EU will play a predominant role in deciding the outcome of the current World Trade Organization (WTO) negotiations on agriculture.

Of the three reasons, the first will likely have limited implications for Alberta's/Canada's agri-food export interests. Currently, only 3.3% of Alberta's and 5.5% of Canada's total agri-food products are destined to the EU. In particular, for certain products of special interest to Alberta, such as beef, current access to the EU market is negligible, partly due to market access restrictions, such as quotas and/or high tariffs and the beef hormone ban. It remains to be seen how much additional market access the EU will concede in the current WTO negotiations on agriculture, but it is realistic to assume that it will not be substantial. The recent CAP reform has not lowered intervention prices, except for dairy and two minor crops. As a result, the EU has limited scope for liberalization of border measures for this would undermine its artificially high domestic prices. In fact, even the limited market access concession the EU can offer in the current negotiations would derive mainly from the 1999 (or so-called agenda 2000) reform that reduced market price support and anticipated favorable world price situations in the future.

More important to Alberta's/Canada's agri-food industry is what the CAP reform could allow the EU to do in the domestic and export subsidies front. As a major exporter and top subsidizer of agri-food exports, the EU's impact on the world agri-food market is significant. During the 1999/2000 marketing year, for example, the EU's actual aggregate Measurement of Support (AMS) --- the monetary measure of the most trade distorting forms of support subject to reduction commitment under the WTO agreement on agriculture --- was some €48 billion, its direct payment under production limiting programs (or the so-called blue box criteria) was €20 billion, and its export subsidies over €2.5 billion. Bound levels of support, i.e., allowable subsidies under the WTO Uruguay Round Agreement on Agriculture are even higher: whereas no limit actually exists for blue box, EU's bound AMS support stands at €67.2 billion (cf., U.S. AMS support of $19 billion and Canada's $4.3 billion CDN) and its export subsidies at €7.5 billion.

The outstanding feature of the June 2003 CAP reform deal is the partial de-linking of direct payments from production in the cereals and livestock sectors. Consequently, the EU production and exports are projected to decline in these sectors, which will have a positive impact on world prices and thus would benefit Alberta's/Canada's export interests. Some of the products that obtain the highest subsidies in the EU such as wheat, beef, pork and a number of minor products (e.g., fodder and malting barley) compete with same products from Alberta/Canada for world market shares.

At the same time, since most EU direct payments have been made under the blue box, the decoupling move could allow the EU to make significant concessions in this box. However, even this move is a qualified achievement for a number of reasons. First, the decoupling can be partial or full and is not uniform across products. Second, access to decoupled payments will be tied to meeting certain environmental, food safety and animal welfare practices and standards. These cross compliance requirements will discourage exit from farming, hence the production distorting effect of such payments is not entirely removed. Third, decoupled payments do not guarantee that production will not occur, hence the dilution of the principle.

The June 2003 CAP reform has not affected the EU's most trade distorting form of domestic support (called amber support). Amber support, which in the EU takes mainly the form of market price support, is reduced only in the dairy sector and for two minor crops, namely rice and rye. The EU 's ability to make substantial reductions in amber box support (e.g., a 60% reduction) as well as reductions in export subsidies would therefore derive mainly from the Agenda 2000 reform under which significant reductions were made in intervention prices for cereals, livestock and dairy products and from future reforms currently under discussion in the EU.

The third benefit for Alberta/Canada from the CAP reform comes indirectly. The reform could overall allow the EU to move away significantly from its historically defensive positions and contribute toward a successful completion of the Doha Development Agenda (DDA). A successful conclusion of the Doha round would in turn open up opportunities for Canada's/Alberta's exports not just in the EU, but also around the 100-plus countries to where Alberta's/Canada's agri-food exports are shipped, by lowering protection and, even more importantly, by strengthening the world trading system in terms of making it more stable and predictable. The CAP reform has indeed allowed the EU to show some flexibility in domestic support reduction. While the EU remains opposed to total elimination of export subsidies, it has proposed for the elimination of export subsidies for certain products of particular interest to developing countries.

Clearly the reforms adopted are much less impressive than as initially proposed by the European Agriculture Commission. Budgetary pressures, expanded membership and external pressures had led the Commission in the direction of an aggressive reform path, but as is often the case, political considerations did not allow for these to be effected. They will allow the EU some negotiating flexibility in the Doha round on domestic support and export subsidies on many commodities, but only limited direction on market access, and that of course is the key for many countries.

Production inducing or distorting forms of farm support are less and less tolerated in an increasingly integrated world trading system. These forms of support have also proved to be inefficient income transfer mechanisms to farmers. Bold reforms of production distorting support policies are necessary, sooner rather than later, so that less competitive sectors can adjust to market reforms that will inevitably take place through the multilateral trade negotiations. In this light, the EU's move toward decoupled farm support is a significant step in the right direction. Given the political strength of the farm lobby in the EU, the measures taken are politically bold. This kind of leadership can serve to demonstrate to other countries that politically sensitive reforms are possible. Indeed, for Canada, they are desirable since they have the added economic benefit of offering export opportunities for the bulk of the agri-food industry including for the supply-managed products in a reformed and expanding international market for these products.

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1. Introduction

The European Union (EU) Council of Agricultural Ministers has passed yet another reform agreement for the Common Agricultural Policy (CAP) on June 26, 2003. Both internal and external pressures contributed to this reform, which took place amidst the EU enlargement process and the Doha round of World Trade Organization (WTO) negotiations. While a full scale and detailed analysis of the impact of this reform is beyond the scope of this paper, a preliminary and broad assessment of implications is done and presented in the following sections. The analysis is focused mainly on four questions: First, will the CAP reform lead to improved market access inside the EU for Alberta's/Canada's agri-food exports? Second, will the CAP reform contribute significantly toward leveling the playing field in world agriculture markets to benefit less or non-subsidizing countries? Third, will the reform allow the EU to engage effectively and proactively in the multilateral trade negotiations?

These questions are addressed in the following sections. Sections 1- 3 provide background information on the genesis, evolvement, and timeline of CAP reforms. Section four discusses the major components of the recent CAP reform. Section five addresses the three questions mentioned above in the context of the implications of the CAP reform to the current WTO Doha round negotiations. Section six analyzes the implications of the EU CAP reform for Alberta's agri-food interests. Section seven provides concluding remarks.

2. Genesis of the CAP

The Common Agricultural Policy (CAP), which went into effect in 1962, is an integral part of the agreements that established the European Community (EC) [1]. It is among the most expensive EU policies commonly administered and funded by Member States. The CAP is based on three fundamental principles: free trade within the Community based on common prices, preference for Community produce in Community markets, and joint financial responsibility.

The stated objectives of the CAP (contained in Article 39 of the Treaty of Rome) include: (i) increasing agricultural productivity through technical progress and efficient allocation of resources in order to ensure a fair standard of living for farmers; (ii) stabilizing internal markets; (iii) assuring availability of food supplies; and (iv) ensuring reasonable prices to consumers. Over the 40 years of

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[1] The European Union (EU), signed in 1992, is a larger entity than the European Community (EC). The latter is an economic and political confederation of 15 European nations and remains the core of the EU invested with broadly economic and social policy. In addition, the EU encompasses two other organizations, one, dealing with common foreign and security policies and, the other, dealing with cooperation on justice and home affairs. The governing body of the EU consists of four major interlinking institutions: (1) The **European Commission** consists of nominated commissioners, and initiates EU policy on the economy in particular but, increasingly, also on environmental and foreign and security affairs. The legislation it drafts is subject to amendment by the European Parliament and to ratification by the Council of Ministers. (2) The **European Parliament,** consisting of elected MPs, has mandates to approve the president and members designate of the European Commission or force the Commission to resign through a vote of censure. The parliament has also direct jurisdiction on the EU budget, which it may amend or reject and on which it generally has the final vote. In other policy and legislative areas, the Parliament is largely a consultative body whose opinions are not binding. (3) The **Council of Ministers** is the central governing body of the EU that has the final vote on legislation proposed by the Commission and deliberated by the Parliament. Membership to the Council is fluid in that it consists of ministers appropriate to the subject then under consideration by the council. Therefore, there are, in effect, many 'Councils' consisting of ministers from each member state with specific portfolios - such as agriculture, transport and social affairs. The foreign minister is generally regarded as the coordinator and main representative of each government's delegation. (4) The **European Court of Justice (ECJ)** is the court of last resort whose decisions have immediate effect.

its existence, the CAP has achieved most of its original stated objectives. Most importantly, the EU food production has greatly increased as a result of technological advances in agriculture.

Following enhanced agricultural productivity food self-sufficiency, the EU agricultural policy focused mainly on stabilization of farm incomes and internal prices, which improved individual farm household incomes dramatically. Internal prices for most products, including grains, milk products, and beef and veal have been stabilized generally well above world prices. These prices have been protected by a combination of devises including *variable import levies*, unlimited intervention purchasing at guaranteed prices, and *export restitution*. Clearly, the CAP's objectives were pursued at a tremendous cost both domestically -- to EU consumers and taxpayers-- and internationally —, to countries with open agricultural markets that have to shoulder the burden of adjustment costs of any market instability.

This is not to suggest that the CAP has resolved the EU farm problem itself on a sustainable basis. Most existing forms of farm support, both in the EU and elsewhere in the developed world, simply don't resolve the farm problem. This is partly because modern farm problems are the consequence of the same farm support policies. Output, input or acreage subsidies and market price support encourage surplus production that inevitably leads to more depressed domestic prices [2]. Governments then use export subsidies, export credits and food aid to dispose of surpluses and thus maintain the high domestic prices. But when a number of countries apply the same measures simultaneously, world prices fall, in turn affecting farm income and necessitating more government support, and the spiral goes on. Studies show that support policies in developed countries cancel out each other's positive income effect by as much as 65%.

3. The Pressure for CAP Reforms

Farm subsidies, almost everywhere, begin in times of hardship. In Europe, these were introduced after the Second World War to encourage increased food production and ensure food security. Europe had long overcome the hardships that necessitated farm subsidies. But farm support continued rather as a form of social policy for income re distribution. The rationale for such policy is generally that, without government assistance, farm incomes would be much lower than non-farm incomes. Indeed, agriculture's employment share in the EU is larger than its GDP share, implying that per capita GDP (i.e., per capita farm income excluding government support) in agriculture is lower than its counterpart in the non-agriculture sector. What is conspicuously unnoted in such rationalization is, however, the fact that lower per capita GDP in agriculture is partly a result of the same social policy that contributes to resource misallocation and keeps non-efficient farmers on the land.

Since around the Mid-1980s, both internal and external factors put mounting pressure for fundamental reform of the CAP. **Internally**, budget costs, which were not crucial in the initial periods of the CAP, became over time a strain on the overall EU budget as high intervention prices and technological advances resulted in chronic surpluses.[3] Public support for the CAP as a desirable

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[2] Even without such subsidies, agricultural production has increased dramatically in developed countries over the past half century due to technological advancement. On the other hand, domestic consumption of agricultural products has not grown by the same rate because food consumption is governed by a different set of economic laws, such that it grows less proportionately with income. Population growth, another variable that determines long run demand for food, has also stabilized in developed countries.

[3] The 1992 and 1999 CAP reforms have not mitigated the budget problem. Both reforms introduced compensatory direct payments for the reduction in intervention prices pushing the CAP budget to new heights. In 2000, CAP outlays at €41 billion constituted 44% of overall EU budget, which rose to 47% in 2001.

social policy also declined over time as CAP benefits progressively concentrated on a small percentage of farmers that are relatively wealthy. Finally, the CAP's farm support mechanisms, like most forms elsewhere, have proved to be poor income transfer devices for needy farmers; benefits often capitalized into farmland and other input prices. Some estimates put the income transfer efficiency of existing forms of farm support at a mere 25 to 30%.

Externally, the EU's use of export subsidies to dispose of its huge surpluses of most products led to conflicts with other agricultural exporting countries. For example, the Export Enhancement Program (EEP) of the U.S was a introduced to counter the EU's export subsidies. This subsidy confrontation and global pressure from other exporting countries, such as the Cairns Group countries together with the budgetary problems each subsidizing country was experiencing resulted in bringing agricultural trade under the GATT/WTO rules and disciplines during the Uruguay Round. In response, EU launched more serious reforms of its common agricultural policy as discussed below in greater detail. 3.1 Recent CAP Reforms (1992 – 2003)[4]

3.1.1 The 1992 CAP Reform

The 1992 reform was a major departure for the CAP in that it reduced reliance on market price support in favor of support through direct payments. Reforms affecting 75% of production were introduced progressively starting in 1993. Cereal intervention prices were reduced by 30%, beef prices by 15% and dairy product prices by 5%. Supply controls (already in place for dairy and sugar) were extended to arable crops through mandatory land set-asides. As compensation for price reductions, farmers received permanent compensatory payments linked to land use for arable crops. With lower intervention prices, per unit as well as total export subsidies were also reduced. However, the direct payments more than offset reduced budget costs of export subsidies. Direct payments accounted for 70% of all the EU expenditure for market support and direct payments by 1996. Thus a significant portion of the cost of agricultural support was transferred from consumers to taxpayers.

Pressures and constraints arising from the General Agreement on Tariff and Trade (GATT)/WTO have played a critical role in the 1992 and subsequent CAP reforms. While earlier GATT/WTO rounds (Dillon (1961-62), Kennedy (1963-67) and Tokyo (1973-79)) had limited impact on the CAP and overall world agricultural trade, the **Uruguay Round (1986-94)** brought about a radical change in the rules governing global agricultural trade. It was in the middle of this round (May 1992) that the EU Agriculture Council adopted a reform package that put the CAP on a fundamentally new basis, mainly in the area of crops and cereal-based livestock, by reducing the level of price support significantly and increasing direct payments as a compensation. Soon after this reform, the EU brokered the so-called Blair House Accord with the U.S., leading to the conclusion of Uruguay Round a year later.

3.1.2. Agenda 2000

In March **1999**, the EU Council adopted the so-called "**agenda 2000**" reform package with the objective of smoothening the EU enlargement process of adding ten new members of Central and

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[4] Earlier CAP reforms involved mainly the imposition of quota systems and/or the reduction and management of these. In **1968**, EU introduced quotas for refined sugar. In **1984**, very high stocks of skimmed milk powder (SMP) and butter forced EU to impose milk delivery quotas. In **1986**, milk quotas were reduced as were support price level for milk products and meat during periods of surpluses. In **1988**, the EU adopted its first general program to address the 'structural' (i.e., chronic) surpluses. For about half of all agricultural production, maximum guaranteed quantities (**MGQs**) were established, beyond which the level of support is automatically reduced. The effective intervention prices were further reduced due to stricter rules on quantity and minimum quality.

Eastern Europe (CEE) countries, easing the pressure on the CAP budget, and ensuring that the EU meets its existing WTO commitments while providing the basis for future negotiations. Agreement was reached to lower intervention prices (e.g., for cereals by 20%) accompanied by compensatory direct payments. These measures were essentially extensions of the 1992 reform, but Agenda 2000 attempted to also rein the CAP budget at the same level in real terms until 2006. The reform brought domestic cereal, milk and beef prices closer to world price levels.

Agenda 2000 also included agreement on what came to be known as the "Second Pillar" of the CAP or **Rural Development Regulation** (RDR). This agreement allowed member States to divert up to 20% of compensatory direct payments to fund agri-environmental schemes. However, its application by individual member states was very minimal. All said and done, the Agenda 2000 reform failed to mitigate the problem of surplus accumulation in the EU, because of continued high yields, little or no growth in domestic consumption, and WTO constraints on export subsidization.

3.1.3. The 2003 CAP reform

The next major CAP reform was scheduled for post enlargement in 2006 when Agenda 2000 will have run its course. However, as part of the Agenda 2000 agreement, the European Council had mandated the EU Agriculture Commission to conduct a **mid-term review (MTR)** of Agenda 2000 in the arable, beef and dairy sector in 2002/03. Consequently, the Commission under Franz Fischler released a CAP reform proposal on 10 July 2002 and published the draft legislative text on 22 January 2003. The main elements of the Commission's proposals in the MTR included: Decoupling of direct payments[5], reduction of commodity price support as agreed in Agenda 2000, compulsory cross compliance requirements covering environmental, food safety, and animal welfare standards, and degression and mandatory modulation of direct support where direct (decoupled) payments would be reduced progressively (both over time and across income levels) and a proportion of the "proceeds" generated transferred to "pillar 2" (rural development) of the CAP.

The EU Council of Agriculture Ministers reached the final deal on 26 June 2003 that abandoned the more radical aspects of the original proposal in order to broker a deal between polarized positions of Member States. In the end, the reform agreement passed by a qualified majority.[6]

4. Major Components and features of the 2003 CAP Reform Agreement

4.1 Decoupling

In place of the commission's full or close to full decoupling proposal, agreement was reached to decouple 75% of direct payments for **arable crops**, with the other 25% staying linked to production to "prevent land abandonment". For **durum wheat**, the decoupling covers 60 percent of subsidies, with 40 percent staying linked to production. In the **livestock** sector, member states are given the option of choosing different combinations of decoupling for different elements of the livestock subsidies. Overall decoupling in this sector would reportedly amount to about 70 percent. **Dairy**

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[5] Decoupled income support is defined in the WTO Agreement on Agriculture as payment that is based on a clearly defined criteria in a fixed base period, whose amount in any given year is not dependent on the type or volume of production, or the factor of production employed or the domestic or international price of the product in any year after the base period, and no production is required to access such payment.

[6] The Mediterranean countries (Portugal, Spain, Italy and Greece), Ireland, and France were opposed to the MTR. These are the principal beneficiaries of the CAP. On the other hand, the U.K., Germany, Sweden, Denmark, and the Netherlands advocated the CAP reforms, although some of them had reservations on certain aspects of the original reform proposal. Germany and, to a lesser extent, the UK are the principal net contributors to the EU budget.

payments will be included in the decoupled single farm payment (SFP) from 2008 once intervention prices are lowered to agreed levels. But, Member States can introduce the system earlier if they wish to. Decoupling for cereal, beef, and sheep and goat sectors starts in 2005, with a grace period extending to 2007.

4.2 Cross Compliance

There are **a number of cross compliance** requirements related to environmental, food safety and animal welfare standards that farmers will be required to meet in order to qualify for full direct payments. These requirements could indeed improve the environment, food safety and rural scenery. But the cross compliance requirement was largely a political decision to convince the EU public that farmers are getting support for doing something in return. Farmers generally prefer price support to direct lump sum payments due to the uncertainty of a stable political support for the latter as a justifiable form of farm assistance.

4.3 Commodity price support

Mainly due to France's objection, the council failed to agree on any level of reduction in intervention prices for **cereals,** even the 5% reduction, which was the last installment agreed under Agenda 2000. Also, against the Commission's proposal for total abolition, the Council agreed on a 50% reduction of monthly increments in cereal intervention prices. In the **dairy sector**, butter intervention prices will be reduced by 25% (with new purchase ceilings) over four years, while intervention prices for skimmed milk powder will be reduced by 15% over three years (2004-2006).

4.4 Degression and Modulation

The concept of degressivity, i.e., successively larger cuts of direct payments for bigger farms, is replaced by a 'financial discipline' mechanism to be decided annually by the Council. The modulation proposal is retained as proposed by the Commission, thus direct aids will be reduced progressively by 3% in 2005, 4% in 2006, and 5% in 2007 onwards until 2013 to create extra revenue for rural development.

4.5 Re-nationalization of the CAP

The July 26, 2003 CAP reform leads to the re-nationalization of the CAP in important respects. Member States are now given the right to decide which subsidies to decouple or not to decouple, for example, in the livestock sector. They decide the magnitude of decoupling for some commodities, when to start decoupling within the grace period, and how to use the rural development money —up to 80% of modulation money remains within or goes back to individual Member States. They can also extend up to 10% top-up direct payment to their own farmers.

The re-nationalization of the CAP will likely make it rather a complex, not a simplified, policy. This fact among other things could make the Commission's task of formulating a EU-wide position a difficult process in trade negotiations and more so with the impending enlargement. It could also create complications in intra-EU trade; varying levels of decoupling among member States could create differential production incentives, particularly in the livestock sector that would alter intra-EU trade flows. How member states will respond to such outcome is too early to judge.[7]

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[7] Regardless, supporters of the re-nationalization of the CAP argue that the CAP is not well suited to income distribution; such policies are better handled by individual Member States in conformity with their income tax and social security systems.

4.6 The CAP Budget

More than 90% of the EU budget is financed through member states' contributions made from national treasuries. This makes the EU budget not directly connected to taxpayers obscuring the burden from the public.* The EU's multi-annual budgets are set under the so-called 'financial perspectives'. However, these budgets are not revised in any major way from one financial perspective to the next; they are only tweaked at the margin where there is least resistance.

The EU's enlargement, which is viewed as a geopolitical necessity with long-term economic benefits, will bring in a farm population of some four million who would be sooner or later included in the CAP payouts. The enlargement will likely add significant pressure on the CAP budget. The surplus problem is likely to exacerbate, particularly for beef, pork, and rye, as the farmers in the new member countries respond to relatively high EU prices. Stringent EU rules and regulations on minimum quality standards could slow down production responses in the new member countries, but to what extent and for how long is early to judge. .

Apparently, the current CAP expenditure system is unsustainable. In realization of this, the Brussels Summit of October 2002 put a new ceiling on CAP expenditures, which will be effective from 2007 to 2013. Savings resulting from recent CAP reform will be used to cover additional expenditure for the ten acceding countries. Direct CAP payments for farmers in the newly acceding countries will start in 2004 at 25% of what EU-15 farmers get, increasing to 30% in 2005 and to 35% in 2006, and finally rising to 100% by 2013.

5. Implications of the CAP Reform for WTO Agricultural Negotiations and World Agricultural Trade

Since decoupled payments, create less or no incentive to produce more, part of the price depressing effect of the EU direct payments is removed. It is estimated that production will decline in the EU's cereal, beef and sheep sectors because of the decoupling of direct payments. Consequently, both domestic and international prices for these products, especially for cereals, could rise. The extent of the decoupling could also leverage EU's position in the WTO negotiations significantly, in particular, with respect to **domestic support** reduction.

5.1. Effects on Blue Box Programs

The majority of the EU's direct payments, currently made under production limiting programs commonly known as **blue-box,** are exempt from reduction commitment under existing WTO Agreement on Agriculture. In the 1999/2000 marketing year, the total expenditure on these programs was around €20 billion, 76% of which was made in the cereal sector and the remainder in the livestock sector.

In the current (Doha) round of WTO negotiations, proposals have been made from many Members for the abolition of the blue box, the justification being that blue-box programs distort production and trade in spite of their production limiting requirements. Consequently, modalities and framework texts on the table recommend for the capping and/or subsequent reduction of blue box support. Only a few countries use blue box with the EU being by far the principal user.

By decoupling direct payments, the EU has essentially moved a substantial portion of its blue box payments into a green category under **Annex 2**, paragraph 6 of the Agreement on Agriculture. A

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* Surveys reported that half of Europeans have never heard of the CAP, and only 19% are relatively aware of its existence, and the remaining only have a vague idea about the CAP.

75% decoupling in the cereal sector alone can translate into a 57% reduction in overall blue box programs. This amount could, for example, allow the EU to more than satisfy a 50% reduction in blue box as was recommended by the former WTO agriculture Chair, Mr. Harbinson, in March of 2003.

The blue box will not be abolished in this round, however. Not only because the EU cannot get rid of all blue-box payments, but also because the U.S. has abandoned its original position and is now in support of its retention, apparently, to use it for its counter-cyclical programs under the 2002 Farm Bill. The revised WTO modalities framework, circulated at the 5th ministerial meeting in Cancun recommends the capping of blue box payments at 5% of the value of domestic production in the 2000-2002 period, with further linear reduction over an agreed upon period. For the EU, whose total value of farm production during 2000-2002 was around $225 billion, this proposal would cap the blue box at around $11.3 billion. With the recommended subsequent cuts, the blue box could go well below the $10 billion mark by end of the implementation period. (Under the Harbinson 's 50% reduction proposal, the EU's blue box would be bound at $10 billion). Depending on expected levels of decoupling in individual Member States, the EU could commit itself to a 60% or more reduction in blue box.[9] That is, agreeing to the revised Cancun framework for blue box reduction or even to the lumping of blue box to amber box as was recommended by Mr. Harbinson in March 2003 (It appears that a 60% reduction is likely to be the upper end of reduction for amber box if the Cancun framework proposal were to be adopted for establishing modalities).

5.1.1 Is Decoupling the Remedy for Distortionary Direct Farm Subsidies?

Notwithstanding EU's leveraged position by the June 2003 CAP reform to fulfilling future WTO obligations, in particular in domestic support and export subsidies, some WTO members do not regard decoupling as a solution for ending production and trade distortion. In particular, developing countries are not comforted by the move toward decoupled payments, which they termed **box-shifting**.

First, while decoupled payments are, by definition, production neutral, they do not guarantee the absence of production, hence the dilution of the principle. **Second**, only under rare situations can any farm support become entirely production or trade neutral. If farmers are risk averse, any policy that reduces risk or increases income will affect production and trade. For a farm policy to be entirely decoupled, not only should equilibrium level of production or trade be the same as without the policy (the usual understanding of decoupled payments), but also quantity adjustment in response to external shocks should be the same as it would be if the policy were not in place. **Third**, in the EU case, access to decoupled payments is tied to meeting certain environmental, food safety and animal welfare standards. Since these cross compliance requirements discourage exit from farming, the production effect is not entirely removed.

Whether the EU's enlargement will contribute to minimize the production and trade effect of direct payments may be rather an empirical question. On one hand, the spread of a fixed sum of money among a larger number of farmers will have a diluting effect of these payments on production by weakening the wealth effect of risk taking behavior among the wealthier farmers that are now concentrated in the current EU membership of 15 States (EU-15). However, by the same token, redistribution of the direct payments among a less wealthy farmers concentrated in the newly acceding countries could encourage production in these countries due to newly acquired wealth effect on risk taking behavior. In fact, one view is that rich farmers, relative to poor ones, tend to use

[9]Note that the June 26, 2003 CAP reform on decoupling sets the maximum amount (percent) of payments that could remain coupled to production for individual products. That is, individual Member States can, if they wish to, set lower levels of coupled payments, which would mean higher level of decoupling.

their extra income from government support for leisure, and other activities rather than use it to produce more.

5.2 Effects on Amber Box payments

Amber box payments are the most production and trade distorting forms of domestic support. In the WTO Agreement on Agriculture, amber support is quantified by what is called **Aggregate Measurement of Support (AMS)** and is subject to reduction commitments with a de minimis allowance.[10] The EU's bound Aggregate Measurement of Support (AMS), by far the largest among all WTO members, is €67.2 billion. Its notified (actual) AMS for 1999/2000 marketing year was close to €48 billion. About 70% of the EU amber support is in the form of market price support, which is the difference between the administered price (such as intervention price) and a specified fixed (1986-88) base period reference price ("world market price") multiplied by the quantity of production eligible to receive the administered price. By far the largest price support (around 39%) for the 1999/2000 marketing year was made for beef, which also takes up the largest share (27%) in overall amber (AMS) support. Other products receiving high amber support include white sugar (12%), butter (9.3%), common (i.e., non-durum) wheat (6.1%), barley and tomatoes (5.3% each), apples (4.6%) and olive oil and wine (4.3% each). For comparison of EU domestic support with selected countries, see **Table 2** at the end.

The June 2003 reform has left intact **market price** support in the most important sectors—cereals, sugar and beef. Rice intervention price will be reduced by 50%, but AMS support for rice is insignificant to begin with (less than 1% of total AMS). In addition, any effect from the reduction will be substantially offset by the compensatory increase in the direct (coupled) payment from €52/t to €75/t. Rye intervention will be abolished, but, again, rye support is negligible in absolute dollar terms. Significant market price reform is made only in the dairy sector, which will see a reduction of 25% in intervention prices for butter by 2007, and a reduction of 15% for skim milk powder by 2006. Compensatory direct payments that will follow these reforms will be in decoupled form.

Since the recent CAP reform has not provided the EU with much room for reducing its amber box support substantially, its eventual commitment under the DDA will be mainly dependent upon the **Agenda 2000** reform. This reform had lowered market price support in almost all the important sectors from 2000. For example, intervention prices for cereals and beef have been reduced by 15% and 36%, respectively (thus the current share of these two sectors in total AMS is significantly lower than in the 1999/2000 marketing year reported above). Still, the combination of Agenda 2000 and the June 2003 reform will fall short of the 60% reduction in AMS support recommended earlier by Harbinson in March 2003 and is likely to serve as the upper limit in a eventual harmonized amber support reduction commitment.[11]

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[10] AMS is calculated as the sum of price support (including administered price support and direct per unit output subsidy, such as deficiency payments), product specific support (e.g., input subsidy), and non-exempt (i.e., non-green) generally available direct subsidy. A product-specific amber support that is less than 5% of the value of that product and a generally available amber support that is less than 5% of the total value of agricultural production fall under the so-called de minimis category and is exempt from reduction commitment. That is, AMS reporting to the WTO does not include support within the de minimis limit. In the current WTO Doha round negotiations, there is support among most major participants for reducing the de minimis level.

[11] The Agenda 2000 and the 2003 reforms in combination would lower overall market price support by around 46% from its 1999/2000 level. Given that actual AMS was 23% less than bound level in that year and that market price support constitutes 70% of total AMS, the two reforms would lower actual AMS by around 48% relative to bound level, assuming that actual AMS remains at the 1999/2000 level.

However, the EU agriculture commission has just opened discussion on a reform proposal for sugar, olive oil, cotton, and tobacco. Sugar is a highly subsidized product in the EU, accounting for 12% of EU AMS support in 1999/2000 marketing year. Olive oil, tobacco and cotton accounted for 4.3, 2.1 and 1.3% of AMS support, respectively. These additional future reforms, if brought to fruition, would allow the EU to meet a 60% reduction commitment. Further, reforms in the mentioned sectors would help correct the existing imbalance in the CAP reform across commodities, thereby enabling the EU to even agree to the capping of product specific AMS (which would amounts to a level of commodity specific or disaggregated reduction of amber support).

5.3 Effects on Market Access

If the rationale for reducing production and trade distorting subsidies is to allow competitive production, these measures must be complemented by reduction in protection or improvement in market access. Developed countries use border measures such as import tariffs or quantitative restriction such as TRQs mainly to protect domestic policies from being undermined by external competition. The EU's failure to lower intervention prices in the recent CAP reform will most of all constrain its flexibility in the **market access pillar** of the Doha negotiations. The EU will not likely agree to substantial reduction of import tariffs or expansion of TRQs as these would lead to reduced domestic prices, which, given the relatively high level of intervention prices, will in turn lead to increased deficiency payments or intervention purchases. Such scenario is not compatible with the EU CAP budget that will be capped at the 2006 level until 2013 and distributed over a larger number of farmers following enlargement.

In the EU's interest, any eventual framework and modality for tariff reduction in agriculture will likely have a blended formula that would allow differential treatment of so-called sensitive products.[12] This would allow the EU, indeed, all developed countries, to shelter their import sensitive products by putting them in a category that will only be subjected to minimal tariff reduction. A possible agreement on capping tariffs at a certain maximum level will likely not cause a major concern for the EU, simply because any cap that would accommodate other high tariff countries such as Japan, non-EU West Europe, and even Canada for certain products will be of such magnitude that will likely not affect EU tariffs. In addition, loopholes to exempt a "very limited" number of products from reduction commitments for reasons of "non-trade concerns", as proposed in the latest framework text circulated at the Cancun Ministerial Conference, would provide the EU with additional leeway.

5.4. Effects on Export Subsidies

The limitation of the recent CAP reform to lower market price support and the continuation of a significant proportion of the coupled payments would not allow the EU to eliminate all **export subsidies**. Expenditure wise, current EU export subsidies are concentrated in sugar, dairy products and beef. Quantity wise, utilization rate is higher for wheat than for other products. Depending on the EU's competitive position, both expenditure and quantity utilization rates could be crucial. In any case, except for dairy, where intervention prices will be reduced, the EU will encounter significant constraints in reducing export restitutions in particular for the livestock sector.[13]

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[12] The concept of a blended formula, first proposed jointly by the U.S. and the EU in August 2003 has been more or less adopted in all the framework texts circulated later (see framework texts prepared by the Chair of the WTO General Council, the G-21 (a group of developing countries) and the Chair of the Cancun WTO Ministerial Conference).

[13] This constraint will be the stronger the longer the euro remains stronger vis-à-vis the U.S. dollar since intervention prices are set in euro while world market prices are generally set in U.S. dollar.

The EU has proposed to eliminate export subsidies only for "products of particular interest to developing countries". This proposal, first adopted by the EU-US joint proposal, has been carried through the text of the Chair of the WTO General council and into the Cancun framework text. However, without a definite timetable for elimination of export subsidies for the remaining products, it will likely prove to be very difficult to make any progress on the agriculture file as major developing countries will be less interested to engage in the negotiations. After the Cancun conference, the US has gone back to its original position of seeking the elimination of export subsidies by a date certain. The EU being almost a unilateral subsidizer of agricultural exports, with most other countries having abandoned export subsidies unilaterally, is isolated and will be under a tremendous political and moral pressure to agree to the eventual elimination of all export subsidies.

All said, the true test of how fundamentally reformed the CAP is now is seen by how much movement the EU makes in its position in the Doha round negotiations. In fairness, the EU has come some distance. Unfortunately, the June 2003 CAP reform and recent EU proposals came late with very little time remaining in the run up to the September 2003 Fifth Ministerial Conference in Cancun, Mexico. There was not enough time to test the real strength of the CAP reform in special sessions of the Committee on Agriculture at the WTO in Geneva before going to Cancun. But it has been observed that in Cancun and since then, the EU has not moved to the full extent of the CAP reform itself. The political rhetoric and self-congratulatory remarks by the EU agricultural and trade ministers about the CAP reform have not been yet translated into proactive steps to contribute toward a meaningful and timely conclusion of the Doha round.

6. Implications of the EU's CAP Reform for Alberta's/Canada's Agri-food Industry

The CAP reform has significant implications for Alberta's/Canada's agri-food industry because the EU is both a major importer and exporter of agri-food products with significant impact on world demand, supply and price situations. As the second largest exporter, its agri-food exports compete with Alberta's/Canada's exports in the world market. Further, because of its market power both on the import and the export side, the EU position carries a substantial weight in deciding the progress and final outcome of the negotiations on agriculture.

6.1 Market Access

Despite the fact that the EU is the largest importer of agri-food products in the world, currently, only 3.3% of Alberta's and 5.5% of Canada's total agri-food products are destined to the 15 Member States. In particular, for certain products of special interest to Alberta, such as beef, current access to the EU market is negligible due to market access restrictions such as quotas and/or high tariffs and the beef hormone ban.

There could be future gains in the EU for Alberta's/Canada's competitive agri-food exports if the EU lowers its tariffs substantially. For a number of products, applied tariff rates are generally lower than bound rates in the EU. Therefore, additional market access into the EU for these products would require an aggressive tariff reduction modality that could bite into the applied rates. However, as discussed above, the EU's ability to substantially liberalize boarder measures in the current WTO negotiations is very much constrained. It remains to be seen how much additional market access the EU will concede in the end, but it is unrealistic to expect a substantial market opening in the EU.

6.2. Export Competition

The second largest exporter of agri-food products in the world, the EU is also the highest subsidizer with significant impact on world prices. Although, until recently, the emphasis in the current WTO

negotiations on agriculture has been on market access, reduction in domestic and export subsidies would also result in significant impact in world markets that would benefit Alberta/Canada.

The EU's annual allowable export subsidies for wheat, coarse grains, and beef each are over or close to a billion EURO (1.14 billion EURO, 0.9 EURO billion, and 1.3 billion EURO, respectively). The EU's allowable export subsidies for dairy products and sugar are also substantially high. In recent years, EU's actual export subsidies for cereal and meat products have been substantially lower than allowable limits mainly due to favorable world prices for these products. The EU's export subsidies for sugar, and some dairy products remain very high.

The US and Canada together share only 13% of the total allocation of EU beef quota (which is banned altogether because of EU's hormone beef ban). By far the largest quota allocation (66%) goes to Australia. The remaining is allocated between Argentina (19%) and Uruguay (3%). Overall, the EU export subsidy bound levels and utilization rates substantiate the view that elimination of export subsidies in the Doha round would substantially improve the competitive position of other exporting countries, including Canada.

The CAP reform to de-link direct support from production and, in the dairy case, to reduce price support will have the effect of restricting production to some degree, thereby reducing exports and export subsidies in the EU. This will have a positive impact on world prices that would be beneficial to Alberta's/Canada's export interests. It is difficult to quantify the magnitude of this impact yet as it will also depend on the level of decoupling in individual Member States. Regardless, since the EU is almost a loner as a subsidizer of agri-food exports, both its proposal for a 45% reduction in total expenditure and/or the elimination of export subsidies for certain products of interest to developing countries fall short of the Doha mandate. Alberta's /Canada's agri-food interests will be served best, only with the eventual elimination of all forms of direct subsidies.

6.3. The CAP reform and the EU's Role in the Multilateral Trading System

The basic goals of the WTO negotiations, a predictable and rules-based trading environment, are in the best interest of Alberta's/Canada's agri-food industry. The CAP reform can contribute to such outcomes by allowing the EU to move away significantly from its historically defensive position to bring the stalled WTO negotiations back on track for their successful and timely conclusion. A successful conclusion of the DDA opens up opportunities for Alberta/Canada not just in the EU, but also around the 100-plus countries to where our agri-food exports are shipped, by lowering protection and, even more importantly, by making the world trading system more stable and predictable.

The CAP reform has indeed provided the EU with some flexibility, in particular in domestic support and export subsidies front although its magnitude has not impressed many members of the WTO, in particular, the developing countries. On the other hand, EU's determination to seek new rules and/or extensions of geographic indications (GIs), opening up of the sanitary and phytosanitary (SPS) agreement or accommodation of so-called 'non-trade concerns' have been contested by many WTO members in the current negotiations.

7. Conclusion

The CAP reform necessarily draws significant attention for obvious reasons. The EU is the largest market for agricultural products with much more potential with fundamental reforms. However, the EU has long sheltered its internal markets from external competition by measures allowed for under the CAP. On the other hand, the CAP has allowed the EU not just to become self-sufficient in food production, but also become a major (second largest) agri-food exporter. Huge domestic subsidies

have resulted in chronic surpluses for most products that are disposed of in the world market through export subsidies causing depressed world prices and market share loss for competing countries. The CAP has also historically constrained the EU in mulilateral negotiations for trade liberalization in agricultural products. EU's defensive position has often been one of the major factors for the slow progress and, at times, the collapse of multilateral trade negotiations.

For all the above reasons, the June 2003 CAP reform is welcome news for Alberta's/Canada's agri-food industry. The outstanding feature of the reform, --- the de-linking of support from production, albeit partial, -- is a significant that could limit surplus production in the EU with positive impact on world market prices.

Clearly, the reforms adopted in June 2003 are less impressive than as initially proposed by the European Agriculture Commission. But, given the political strength of the farm lobby in the EU, the measures taken are politically bold. In fact, this kind of leadership can serve to demonstrate to Canada and other countries that politically sensitive reforms are possible and, in our case, even desirable since they have the added economic benefit of offering export opportunities for the bulk of the agri-food industry including for the supply-managed sectors.

The June 2003 reform in combination with the Agenda 2000 reform will provide the EU with some negotiating flexibility in the Doha round on domestic support and export subsidies for many commodities but only limited movement on market access, and that, of course, is the key objective for many countries. The EU has not put its full leverage from the CAP reform on the table yet. But the DDA mandate would require more than what the EU could accommodate on the basis of the last two CAP reforms. Thus future CAP reforms will be absolutely necessary mainly in key export interests such as sugar.

Table 1. Selected EU Tariff Barriers and Alberta's Agri-food Exports (2000/2001)

	Tariffs (Ad valorem or equivalents) (%)		Alberta Exports to the EU	
	Bound Tariff*	In-quota tariff	(Metric tons)	As % of total exports to the world
Wheat	75.2	-	267848	7.9
Barley	85.3	-	1788	0.67
Oats	87.2	-	70	0.07
Rapeseed	0.0	-	2470	0.32
Rapeseed Meal	0.0	-	-	-
Rapeseed Oil	6.4	-	-	-
Sugar	189.5	0.0	-	
Beef	106.3	20	470	0.12
Pork	45.9	22.9	24.9	0.04
Poultry	78.9	39.5		
Peas	14.4	-	407	1.3

Source: WTO country notifications, Statistics Canada, and FAPRI/CARD study: "Analysis of the Proposed Doha Round Modalities." June 2003.

Table 2. Selected EU Export Subsidies commitments (2000)

	Export Subsidies: Uruguay Round Limits	
	Expenditure (million ECU)	Thousand metric tons
Wheat	1141.1	14438
Barley	646.3	7080
Oats	68.2	747
Rapeseed	20.6	79.3
Sugar	497	1277.4
Beef	1259.4	817.1
Pork	117.4	401.8
Poultry	91.6	290.6

Source: WTO, Goods schedules

Table 3. Domestic Support in Selected Countries (billion U.S. dollars)

Country	Bound AMS	Actual AMS (excl. de minimis), 1999/00	Actual de minimis, 1999/00	Blue Box, 1999/00	Green Box, 1999/00
EU	**$78.6**	**$47.6**	**$0.32**	**$19.7**	**$19.8**
Japan	$36.2	$6.7	$0.29	$0.82	$23.6
USA	$19.1	$16.7	$7.4	-	$49.7
Canada	$2.87	$0.63	$0.74	-	$1.18
Australia	$0.26	$0.11	$0.014	-	$0.91
Brazil	$0.97	$0.08	NA	-	$2.79
Argentina	$0.08	$0.08	NA	-	$0.27

Source: WTO, Country notifications